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The Free Trade Deal and Canada's Sovereignty:

Are the Fears Justified?

by

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Many Canadians worry that whatever economic advantages the Canada-U.S. Free Trade Agreement may bring will be bought at the cost of a serious loss of Canadian sovereignty. They fear that Canadian governments may lose their ability to regulate everything from pollution to monopolies; to pursue an independent energy policy; and to retain Canada's much-valued social policies — policies which can be summed up in the slogan, "Canada is a caring society."

The extreme version of such worries is that Canada may have sold its national soul for a mess of trading dollars, and that to oppose the deal is an act of patriotism.

Leaving aside the debate on the Agreement's economic merits, it is the assertion that the Agreement entails a serious loss of sovereignty that seems to have created the most concern among the general public. This is the issue that this *Trade Monitor* addresses. It starts with a brief overview of the arguments to the contrary that are detailed in this *Monitor*, followed by a discussion of how all international agreements affect sovereignty. It then considers the argument that the Agreement's clauses directly affect sovereignty. Finally, it considers whether forces that may follow from the Agreement — but are not directly contained in it — may directly affect Canadian sovereignty.

The Argument against Loss of Sovereignty: A Summary

Canada is a small trading country whose income and employment are heavily dependent on foreign trade. Securing Canada's present access to foreign markets, and increasing that access wherever possible, is important to Canadian prosperity.

The Canada U.S. Free Trade Agreement offers enhanced access to the U.S. market. Although it did not produce all that Canada hoped for, the Agreement compares favorably with all of the world's other trade-liberalizing pacts. At present count, about 14 such pacts exist, covering 71 countries — including all the advanced industrial countries except Canada and Japan. Not one of

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these pacts provides for as much increase in market access, or in security of existing access, as does the Canada-U.S. Agreement. To reject the Agreement on the grounds that it does not do even more for Canadian access to the U.S. market seems to the C.D. Howe Institute to be letting the best be the enemy of the very good.[1]

After careful study of the Agreement and consideration of the arguments put forward by its opponents, the Institute remains convinced that the Agreement does not affect Canada's sovereignty in any of the ways alleged above. Our reasons can be summarized in three main points.

1. *The Agreement calls only for* national treatment, *not for harmonization of either country's policies with those of the other. National treatment is a principle that has served the world's trading countries well since it was first embodied in the General Agreement on Tariffs and Trade (GATT), of which Canada was a founding member in 1947. It is designed to provide maximum policy independence to members of a trading arrangement while eliminating concealed barriers to trade. In the context of the Agreement, it means that Canada is free to follow policies that are completely different from those followed by the United States on any matter whatsoever, so long as it applies these policies equally to Canadian and U.S. firms operating in Canada. By the same token, the United States can adopt any policy it wishes, provided it applies the policy equally to Canadian and U.S. firms operating in the United States. National treatment provides policy independence while ensuring that countries do not use policies as disguised barriers to trade by applying them in different ways to firms of different nationalities.*

2. *The Agreement allows most existing laws that conflict with national treatment to continue, and it exempts from the national treatment requirement a series of sensitive sectors — including culture and all government-provided services. In these so-called noncovered sectors, Canadian governments have complete freedom to discriminate between Canadian and U.S. firms and products. They can even bar U.S. firms and products from the Canadian market.*

3. *Many people have expressed the belief that trade liberalization will require the watering down of all Canadian social programs that are costlier than those in the United States.*

- This belief is refuted by Canada's history — since most of the costly Canadian social programs were developed at a time when the country was removing most of its barriers to trade with the rest of the world, especially with the United States.
- The belief is refuted by the experience of other countries — since countries with very different social programs have successfully traded with each other without there being increasing pressures to harmonize these programs.
- The belief is refuted by economic theory, which shows how the exchange rate adjusts to preserve a country's competitiveness in the face of rising costs brought about by rising inflation, rising costs of social programs, or anything else. If the exchange rate did not make this adjustment, countries with widely different social programs, or widely different inflation rates, could not trade successfully with each other.

Sovereignty and International Agreements

When two or more sovereign countries sign a treaty, they agree to do some things and not to do other things. Thus, it is irrelevant to criticize any particular international treaty or agreement on the grounds that it affects sovereignty — they all do so. Some restrictions on sovereignty are mutually beneficial, as when two countries agree not to increase tariffs on trade with each other or to settle their disputes by appeal to some supranational body. Others may be genuine concessions that one country makes in return for concessions by the other. Thus, the relevant question is: do the two countries' concessions constitute a mutually beneficial package?

There are two main ways in which any international treaty can affect sovereignty.

- First, the treaty itself constrains sovereignty somewhat. These are *direct constraints*.
- Second, when the treaty is put in place, its provisions may set up pressures that constrain governments in their future exercise of sovereignty. These are *indirect constraints* or *harmonization pressures*, which the treaty does not directly call for but which it nonetheless causes.

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Errata

The Free Trade Deal and Canada's Sovereignty: Are the Fears Justified, Trade Monitor 8, by Richard G. Lipsey, which the C.D. Howe Institute released on November 14, 1988, contains an error that this errata sheet corrects.

As released, page 4, column 1, paragraph 7 reads:

> This Agreement does cover management services. This means that if a Canadian province decides to privatize the management of one of its social services, such as hospitals, it must allow U.S. firms to bid on an even footing with Canadian firms for the contract.

This passage should read:

> The Agreement does cover management services. Nonetheless, if a Canadian province decides to privatize one of its social services — such as hospitals — it need not open the bidding to U.S. management firms, because under Chapter 13 of the Agreement all provincial procurement matters are exempt.

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The full statement of how the Agreement protects provincial social services is given on page 4, column 2 of the *Trade Monitor*. The second of the two key bullet points should be revised to include the italicized addition, as follows:

- No province is obliged to allow hospitals or any other public service industry to contract out its management services. It can keep the management of any service out of commercial hands and keep it exclusively in Canadian hands — by government departments, by boards set up the government, or by nonprofit organizations.

- If a province does decide to contract out certain services, *if it allows U.S. firms to bid for contracts*, and if a U.S. firm wins a contract, that firm must operate under Canadian laws, rules, and regulations. No U.S. management firms operating in Canada can use any U.S. practice that is ruled out by Canadian law.

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The Significance of Exclusions

The chapter of the Agreement that deals with services actually lists those sectors that the Agreement covers (Article 1408, Annex). All sectors that are not listed are excluded from the Agreement. Many people have asked why the Agreement does not also list the excluded sectors. By listing only what it covers, however, the Agreement automatically excludes everything else — what was intended to be excluded plus any sectors that may have escaped attention. Maximum *exclusion* is thus guaranteed. Listing noncovered sectors and including everything else would have guaranteed maximum *inclusion*.

To illustrate what exclusion implies, consider the important case of child care. Under the Agreement, child care is a noncovered service. This means that Canadian governments have the power to do all of the following:

- make *any* rules and regulations they wish covering all firms that provide such services, be they Canadian or U.S. (by virtue of the principle of national treatment);
- apply different rules to Canadian- and U.S.-owned firms (since child care is one of the sensitive services that are excluded from the terms of the Agreement);
- set up a nationalized child-care service and prohibit any private child-care firm, whether Canadian- or U.S.-owned (as provided for under Article 2010).

In view of the clear language of the Agreement, the continued assertion that it opens the way for U.S. firms to provide child-care and medical services against the express wishes of a Canadian government, which will then act in ways not approved by that government, is unfounded.

Management Services

The Agreement does cover management services. This means that if a Canadian province decides to privatize the management of one of its social services, such as hospitals, it must allow U.S. firms to bid on an even footing with Canadian firms for the contracts. Critics of the Agreement have objected strenuously to this clause. But consider the following.

- No province is obliged to allow hospitals or any other public service industry to contract out its management services. It can keep the management of any service out of commercial hands and keep it exclusively in Canadian hands — by government departments, by boards set up by the government, or by nonprofit organizations.
- If a province does decide to contract out certain services, and if a U.S. firm wins a contract, that firm must operate under *Canadian* laws, rules, and regulations. No U.S. management firms operating in Canada can use any U.S. practice that is ruled out by Canadian law.
- The clause was inserted *at Canada's request*. Canadian firms seem to be very good at providing efficient management services and have had considerable success in winning contracts in the United States. The full opening of the U.S. market to Canadian management firms should increase their size, efficiency, and employment to the benefit of Canadian income, Canadian employment, and Canadian activities that use their services.

Specific Policies

Many people fear that Canada gave up the right to follow a number of specific policies. Here are a few of the most significant.

Subsidies

The Agreement does not exempt Canadian subsidies from the risk of U.S. retaliation, as many people had hoped it would. It does nothing, however, to increase the risk of U.S. retaliation. In short, the Agreement does not limit the right of Canadian governments to use subsidies as a policy tool for such objectives as encouraging research and development. Subsidies will be at risk to U.S. countervail actions just as much — no more, or no less — as they are now.

When the negotiations for a Free Trade Agreement with the United States were started, they were intended to reduce the risk of U.S. countervail actions against alleged Canadian subsidization practices. Although a code listing the subsidies that would be exempt from countervail was not worked out, the Agreement reduces the risk of such U.S. action in at least three ways.[2]

Direct Constraints

In the two years during which the Agreement was being worked out, many Canadians worried that their negotiators would be pressured into giving up many valued economic and social policies such as regional development subsidies, unemployment insurance, and free medical care. The Canadian negotiators agreed, however, to no new restrictions on Canada's social policies, all of which were exempted from the terms of the Agreement. They also agreed to relatively few restrictions on Canada's economic policies.

The Principle of National Treatment

How were the Canadian negotiators able to maintain Canadian policy independence in almost all respects — outside of committing Canada to free trade and liberalized capital movements, which were the object of the negotiations? To answer this question, it is necessary to understand the principle of *national treatment,* on which the whole Agreement is based.

National treatment allows each country to follow any policy course it wishes. Each can adopt policies that are quite different from those of the other country, with only a single important proviso: that neither country uses these policies to discriminate on the basis of nationality, either overtly or covertly.

For example, Canada can have high taxes on cigarettes sold in Canada, while the United States has low taxes on cigarettes sold there, *as long as* Canada applies its high taxes to both U.S.- and Canadian-made cigarettes and as long as the United States applies its low taxes to cigarettes made in both countries. Similar comments apply to standards. Canada can, for example, require that all children's clothing sold in Canada be nonflammable, provided only that the restriction applies to clothing made in both countries. At the same time, the United States may permit some clothing to be flammable, as long as the rule applies equally to goods made in both countries. The same is true of any economic or social policy that Canada wishes to adopt. On the environment, for example, Canada can have higher standards of pollution control than does the United States as long as it applies these standards equally to Canadian-owned and U.S.-owned firms.

The same principle also applies to much of investment, to the extent that the Agreement covers this topic. Canada can have many policies with respect to investment that differ from U.S. policies. It can regulate how firms invest, where and how much they produce, and a host of other things, as long as these rules and regulations apply to all firms irrespective of their nationality. (In some cases, such as the review of direct acquisitions by U.S firms of Canadian firms that are more than $150 million in size, the Agreement does not require national treatment.)

In summary: *the purpose of national treatment is to leave intact the sovereign right of each country to go its own way on all of its economic and social policies, as long as it does not use these policies as disguised barriers to international trade or investment.*

National Treatment in the Agreement

The use of national treatment as the fundamental principle of the Canada-U.S. Agreement explains why many of the worries over loss of Canadian sovereignty are unfounded, and why the Agreement leaves Canada free to continue with its distinctive social and economic policies. Here is how the principle is embodied in the Agreement.

- The Agreement applies national treatment to almost all trade in goods, to many services, to standards, and to some types of foreign investment.
- It then protects current economic and social policies in two ways. First, *virtually all laws, including some that affect trade in goods, are grandfathered* — that is, they are allowed to continue in existence — even when they offend the principle of national treatment. This is true for a wide range of Canadian policies running from those regulating the export of raw logs to those prohibiting the sale of healthy Canadian oil firms to foreign interests. Second, *the activities of a range of sensitive industries are completely exempted from any national treatment obligation* — examples are child care, Crown corporations, health, education, medical, legal, transportation, and basic telecommunications industries, the export of East Coast fish, the internal sale and distribution of beer, and all cultural industries.

First, any changes in U.S. trade laws that affect Canada must name Canada specifically, must be made only after Canada has been given advance notice, and are subject to review by the binational panel set up under Chapter 18 to review the overall workings of the Agreement. These are serious restraints on U.S. policy independence. For one reason, the U.S. Congress has been reluctant to name any specific country in its legislation. For a second reason, they rule out the tactic of slipping serious trade-law changes into amendments to otherwise innocuous bills — where they do not attract attention until it is too late to stop them. For a third reason, the binational panel will judge whether the proposed changes are in conflict with the GATT or with the articles of the Agreement — a severe constraint on irresponsible changes in U.S. laws.

Second, the binational review panel for antidumping and countervail decisions set up under Chapter 19 of the Agreement will force more objectivity in the U.S. hearings of countervail cases. Knowing that decisions are subject to such review will reduce the scope for political pressure to influence the initial U.S. decisions.

Third, the Agreement mandates negotiations over the next five to seven years on a subsidies code. Agreement may or may not be reached, but it is hard to see any argument against trying, and it is hard to imagine how such negotiations can be ensured without the Agreement.

There is room to debate how effective these restraints will be. Some U.S. trade lawyers who know the workings of the U.S. system believe that the effects will be large. Some Canadian critics hold they will be small. We know of no rational argument, however, to the effect that they will increase the risk of U.S. countervail actions. If the Agreement founders, all of these restraints founder with it.

In view of the above, we see absolutely no support for the commonly expressed belief that the Agreement increases the risk that the United States will decide certain Canadian social policies are subsidies and will then mount countervail attacks against them. Yet, many Canadians seem to believe that the Agreement will have this effect. With respect to the risk of countervail, the only rational question that we can see is, *how much* will the Agreement reduce this risk?

Nationalization

Some people worry that the Agreement prevents a Canadian government from taking over a private industry and putting it under a Crown corporation at any time in the future. The Agreement's chapter on "Other Provisions", however, shows this worry to be unfounded. For example, subject to reasonable rules of procedure, a provincial government can nationalize its car insurance industry and confer a monopoly on a provincial Crown corporation. True, the province must pay reasonable compensation to any U.S. firm it takes over. But surely, few Canadians want to live in the kind of country that ignores the rule of law by confiscating without compensation. Certainly, the rapidly growing number of Canadian firms and individuals who have invested abroad have an interest in preserving the elementary rules of fair treatment of foreign investors.

Environmental Policies

The Agreement provides complete independence on environmental and all other similar policies. It does not give U.S. firms the right to behave in Canada as they do in the United States. In many sectors, including noncovered services and energy, U.S. firms do not even get the right of establishment in Canada. In other sectors, they do get such a right, but they must then operate under Canadian laws, rules, and regulations. Canada's only obligation is to apply its laws, rules, and regulations with respect to the environment or anything else equally to foreign and domestically owned firms.

Specific Sectors

Culture

The Agreement totally exempts all Canadian cultural industries as well as all existing cultural support policies. One clause (2005.2), however, gives the United States the right to retaliate to "equivalent commercial effect" against any new Canadian cultural policy that denies a U.S. firm benefits it otherwise would have received had culture not been excluded. Critics worry that this clause could set Canadians against each other —

for example, if the United States retaliates against a policy to support Canadian publishing with a restriction on Canadian fish exports. Two points are relevant.

- The retaliation clause merely restates a right that the United States (and Canada) now have under GATT rules.
- This clause makes U.S. retaliation subject to the binational dispute settlement procedures. Currently, the United States alone judges the extent of the damage of Canadian policies and the degree to which it will retaliate. Under the Agreement, the United States will have to satisfy a binational panel that it really had been harmed and that its proposed retaliation is commensurate with the harm.

Thus, the Agreement actually improves, rather than worsens, Canada's ability to follow cultural support policies.

Energy

The energy package is a genuine bargain, and reasonable people can disagree on the balance of its advantages and disadvantages. The Institute believes it is a good deal for Canada.[3] Be that as it may, most of the assertions that Canada has given up the right to operate an independent energy policy seem to be based on a misunderstanding of the Agreement. Furthermore, many of the opponents look only at what Canada has given up; they do not consider the energy chapter as a package.

What United States has offered. The Agreement works to the advantage of the energy-producing provinces by providing them with improved access to the U.S. market. The United States can no longer use national defense as a thinly veiled excuse for restricting imports of Canadian energy, nor can it establish quotas or place total restrictions on such Canadian energy exports as electricity and uranium. Guaranteed access to the U.S.market will make possible the development of many Canadian megaprojects that could not be sustained on the basis of the domestic market alone.

What Canada has retained. Canada retains the right to charge what the traffic will bear in any energy market, and to follow all energy policies except those that discriminate between Canadian and U.S. producers or consumers. In particular, Canadian governments can:

- control the rate of extraction of an exhaustible natural resource such as oil or gas;
- tax producers to appropriate undue profits of resource industries (usually called rents);
- subsidize Canadian energy consumers (using such methods as tax credits for energy users).

This seems enough power to allow Canadian governments to pursue any legitimate policy objective at any future date.

What Canada has offered. In return, Canada makes two promises. First, it will not use *government fiat* to impose a lower price for energy sold to the Canadian market compared with that sold to the U.S. market. Second, in times of crisis — declared at Canada's discretion — if it wishes to interrupt normal commercial agreements, it will share available supplies with the United States according to an agreed formula. *Canada is already committed to such sharing rules generally under the GATT and, in the case of oil, under the International Energy Agreement* (although without a specific formula). These seem to be not-unreasonable guarantees, in return for which the United States has pledged to change its policies so as to allow itself to become more dependent on a foreign supplier. Canadians would insist on such guarantees if we were to alter public policies so as to become more dependent on U.S. suppliers.

The outcry in Canada seems to be based partly on a misunderstanding of the sharing and pricing arrangements. Many have argued, for example, that if Canada sells energy to the United States now, it can never stop selling to the United States in the future. In fact, the sharing comes into force only in the case of a genuine emergency in which a Canadian government wishes to override *existing* commercial contracts. On pricing, many have argued that the Agreement rules out multiprice solutions. Instead, the Agreement allows any prices that emerge from bargaining between buyers and sellers. It rules

out only government orders for nationally discriminatory prices.

(Even if Canada rejects the Agreement, it may find it impossible in future to have lower prices for Canadian than for U.S. users, since the new U.S. Omnibus trade bill makes such "upstream subsidies" countervailable.)

Another commonly heard concern is that the Agreement requires Canada to share all of its oil and other energy resources with the United States. This is not so. Canada is obliged to share such resources only if the Canadian government declares a shortage. *Canada makes that decision unilaterally.* Such a shortage is a very rare event; in all normal circumstances, Canada is under no other sharing obligations than to let market forces operate.

The United States cannot declare an emergency and insist on sharing Canadian oil. Only the exporting country can declare an emergency, and sharing is required only if that country overrides existing commercial contracts to supply exports. The purpose of the sharing clause is to ensure that the exporting country will not make arbitrary use of declared emergencies to shut out the importing country from energy supplies on which it has come to depend.

Investment

The Agreement's investment provisions constitute a genuine bargain. Canada has made some concessions — some of which are already called for under the GATT and most of which are usual in other free trade agreements — in return for some advantages.[4] Rational people can disagree on the balance of advantages and disadvantages, but to call the investment chapter a "sellout" is to exaggerate beyond reason.

What Canada has offered. First, Canada will no longer be able to demand certain performance requirements of U.S. firms investing in this country by means of takeovers (although it has not given up all such requirements). Here, Canada is accepting some clear restraints on future policy. The importance of these restraints depends on how one views the international investment scene of the future. Those people who mistrust foreign capital wish to retain the right to impose such requirements. Others hold that the nationality of a firm's owner is irrelevant to its behavior and that, although rules and regulations may be needed to control firm behavior, these rules need not distinguish between domestic and foreign firms.

Second, Canada gives up the right to review all indirect takeovers, and direct takeovers worth between $5 million and $150 million. This still leaves two-thirds o all nonfinancial capital reviewable.

What the United States has offered. Canada will be treated asymmetrically, in that the United States will no longer be able to pass legislation that enforces reviews of Canadian takeovers of U.S. firms. Recently, Canada has become a major foreign investor, and its stock of investment in the United States is increasing three times as fast as the stock of U.S. investment in Canada. Currently, the value of the stock of Canadian investment in other countries exceeds 70 percent of the value of the stock of foreign investment in Canada. In return for raising the level of review of takeovers and ending performance requirements, Canada gets exemption from any measures against foreign investment that the United States may pass in the future. Given the potential for a U.S.nationalist backlash against a rapidly rising stock of foreign investment — a backlash of the kind that occurred in Canada in the 1970s — getting national treatment for Canadian investment in the United States just as foreign investment is becoming a serious issue there may turn out to be one of the most farsighted measures in the whole Agreement.

Some people have worried that the investment chapter increases the exposure of Canada's gas and oil industries to foreign ownership. In fact, the Agreement fully exempts investment in these industries from national treatment. Furthermore, the Agreement still allows restrictions on who may purchase firms that are privatized. (For example, if Petro-Canada were ever to be sold to the public, the Agreement would permit the purchase of shares to be restricted to Canadian nationals.) The charge that the Agreement puts Canadian energy sources up for sale anymore than they are now cannot be sustained.

Is the "Nullification and Impairment" Clause a General Loophole?

Concern has been expressed that the Agreement's clause 2011 on "nullification and impairment" can be used to gain concessions not otherwise allowed for in the treaty. For example, it has been seriously argued that this clause is the loophole through which unwanted U.S,child-care firms will slip into Canada. The clause has been subject to so much controversy that it is worth quoting it, at least in part:

> If a Party considers that the application of any measure, whether or not such measure conflicts with the provisions of this Agreement, causes nullification or impairment of any benefit reasonably expected to accrue to that Party, directly or indirectly under the provisions of this Agreement, that Party may...proceed to dispute settlement.

It should be emphasized that the clause covers only benefits that could reasonably be expected to follow from the Agreement. Since the Agreement, as noted earlier, excludes child care, among many other activities, there is no reasonable expectation of benefits originating in Canada and going to U.S. child-care firms. Hence, such firms have no conceivable recourse to this clause.

Indirect Constraints

An important class of Canadian concerns relates to the indirect effects on Canadian sovereignty that the Agreement may unleash. These concerns are not about specific clauses in the Agreement, but about indirect pressures that the Agreement will set up and that will indirectly constrain the policy options open to future Canadian governments. Many Canadians share these concerns, and the Agreement's opponents have expressed them forcibly. For example, many fear that the unleashing of market forces mandated by the Agreement will make it more difficult to introduce environmental policies in the future. It is also commonly argued that the Agreement will force Canada to water down any social or economic policies that are costlier than those in the United States.

The Influence of Canadian Costs

These and other similar arguments are all based on the view that any policy that raises Canadian costs above those in the United States will not be viable after the Agreement comes into force. According to this view, such policies will make Canadian firms less able to compete abroad. Canadian governments will then face an agonizing choice: to allow Canadian exports and employment to fall, or to remove the costly policies.

To see why these concerns are not well founded, look at actual experience from other times and places and at the reasons behind that experience.

Evidence from Other Times and Places

Past Canadian experience does not support these concerns. The Free Trade Agreement comes close to completing a program started in 1935 when Canada slowly began to reduce its then very high tariffs. By 1986, about 75 to 80 percent of the tariff protection that Canadian industry received against competition from U.S. and other countries' goods had been removed. During that time, Canadian social and economic policies evolved along quite different lines from those in the United States and also became vastly more expensive. If it is true that liberalizing trade causes policy harmonization, then Canadian and U.S. policies should have been 80 percent harmonized already. *The evidence from Canada's history is clear: Canadians can establish, and maintain, distinctive social policies while liberalizing their trading arrangements with other countries in general and the United States in particular.* Opponents of the Agreement have given no reasoned arguments for believing that pressures that were not felt when we went 80 percent of the way toward free trade will suddenly emerge when we go the last 20 percent of the way.

Second, the experience of other countries does not support those concerns. Seventy-one countries — including all the advanced industrial countries except Japan and Canada — are currently in regional trade-liberalizing arrangements. None has complained about lost policy independence. For example, Sweden has many very expensive social policies, yet it has free trade

agreements with all the countries of the European Community, most of which spend much less on social policies. The Netherlands has managed to maintain distinctive social policies, and its prosperity, in spite of its being a member of the European Community — an organization dedicated to fostering policy harmonization in ways the Canada-U.S. Agreement does not include. Throughout history, rich countries have traded profitably with poor countries, and high-spending countries have traded profitably with low-spending countries. *The evidence from other countries is clear: free trade is not the enemy of diversity in social policy.*

The Reasons Why

If this is the evidence from Canada's history and from the experience of other countries, why does trade liberalization not increase harmonizing pressures? Why do countries seem to have so little to fear from harmonizing pressures set loose by trade liberalization?

The answer lies in two basic points. First, there are strong pressures on countries to harmonize their policies, but these pressures are not related to the level of tariffs — they operate on high-tariff countries as well as on low-tariff countries. Second, the apparent pressures exerted by the level of a country's costs and prices will be offset by movements in the exchange rate. Look at these points in turn.

Movements of people and firms are what matter. Harmonizing pressures always exist on social and economic policies of any two countries between which labor and capital can move. For example, if tax rates in Canada exceed those in the United States, some Canadian citizens, and firms, may move to that country. *However, these pressures arise from the international movement of people and capital, not goods and services. Thus, they exist whether or not there is free trade.*

To illustrate, consider the U.K. experience from 1950 to 1985, when many Britons emigrated to the United States to escape high U.K. taxes. The size of this "brain drain" was related to (among other things) the relative levels of taxation between the two countries and to the severity of U.S. immigration laws; it was not related, however, to the level of the tariffs on U.K.-U.S. trade. As these tariffs were reduced through successive rounds of GATT negotiations, the brain drain did not accelerate. Similarly, taxes that hold firms' profits below what they can earn in other countries provide an incentive for them to emigrate, *whether tariffs are high or low.*

The harmonizing pressures that exist today between Canada and the United States are thus related mainly to the ease with which people and firms can relocate — which the Agreement does not alter significantly — rather than the ease with which goods and services can be traded — which the Agreement does alter. There is no reason to believe that the changes brought about by the Agreement will have more than a small effect on harmonizing pressures one way or the other — countless extreme comments to the contrary notwithstanding.

The role of the exchange rate. The second point concerns the exchange rate. Any broad-based social policy that increases business costs across the board — as does unemployment insurance, for example — brings into play a compensating tendency for the exchange rate to change. For example, if the federal government wished to introduce a new measure that would raise all Canadian business costs by 10 percent, this would not destroy the competitive position of Canadian exporters. Instead, it would tend to reduce the exchange rate of the Canadian dollar

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by 10 percent, leaving Canada's international competitiveness unchanged. To illustrate, assume that the cost of a Canadian export is driven up from C$1.00 to C$1.10 by some new tax levied on all firms to cover a new social policy. A fall in the price of the Canadian dollar from U.S.$0.80 to U.S.$0.72 will hold constant — at U.S.$0.80 — the price at which the good must be sold in the United States to cover its costs. This exchange-rate adjustment is the reason why the diverse social policies found among today's trading countries can coexist.

Although economists have understood this point for 200 years, it is not well understood outside the profession. Even businessmen, who generally support the Agreement, can often be heard to argue that they will not be able to compete unless Canada's costly social programs are reduced. A decade ago, many of the same businessmen could be heard saying that if the level of inflation in Canada was not held down to that in the United States, they would lose their ability to compete in the U.S. market. In the event, Canadian inflation exceeded U.S. inflation, the value of the Canadian dollar fell to compensate, and Canadian exporters remained competitive.

The fallacy in the anti-inflation argument is the same as that in the social program argument. Any policy that raises the general level of Canadian costs and prices will lead to a decline in the demand of the Canadian dollar at the original exchange rate (because fewer people will want Canadian dollars to buy the costlier Canadian goods). This, in turn, will lead to a fall in the value of the Canadian dollar on the foreign exchange market, which, in turn, will restore competitiveness by allowing Canadian goods to be sold at lower prices abroad. If this were not so, social policies and inflation rates would long ago have been harmonized among all the world's trading countries.

More General Fears

Many Canadians seem to fear that by trading more with the United States, Canadians will become more like Americans, and that free trade somehow entails the loss of the distinctive Canadian identity. Others worry that since the United States is a declining economy, it is a mistake for Canada to hitch its trading wagon to the sick U.S. horse.

But consider the past history of Canada's trading relations with the United Kingdom. The U.K. economy began to decline around 1890 and has continued to do so through most of this century. The United Kingdom, however, remained Canada's most important trading partner until after the Second World War without Canada's catching the "British disease", or adopting their class system.

Most Canadians would approve of increased trade with the Soviet Union and China. But trading with these countries will not make Canadians become communists, or even caviar and vodka lovers. Markets are where one finds them, and selling in them provide chances for increased national wealth. There is no reason why the exporting country should take on the characteristics, or legal institutions, of the importing country.

Conclusion

The object of the Agreement is to strengthen the Canadian economy by further encouraging the growth through trade that has gone on over the past 40 years. The best way to strengthen Canada's sovereign capacity to further improve its social and cultural policies is to secure and enhance Canadian prosperity. Over the past 40 years, reduction of trade barriers between Canada and its major trading partners (especially the United States) has been accompanied by a flourishing of unique and independent social, economic, and cultural policies. This is because growing trade in a more liberal trading environment has added to the growth of Canada's national income and has enhanced Canada's ability to provide a caring society. Will the dismantling of remaining obstacles to trade with the United States reverse this 40-year process? The answer, we believe, is no.

If, on the other hand, Canada elects to go it alone in a world of rapidly growing globalization, rising protectionism, and increasing numbers of increasingly effective regional trading blocks, prosperity is put at risk. Where will Canada be if the United States, released from all of the constraints the Agreement contains, continues on its increasingly protectionist course? Surely, one way to jeopardize Canada's sovereign ability to improve social, economic, and cultural policies,

which everyone — for and against the Agreement — seeks to preserve, is to fail to adopt policies that promote the growth of Canadian trade, Canadian employment, and Canadian income.

Notes

1 The detailed analysis that supports this conclusion is laid out in Richard G. Lipsey and Robert C. York, *Evaluating the Free Trade Deal: A Guided Tour through the Canada-U.S. Agreement*, Policy Study 6 (Toronto: C.D. Howe Institute, 1988); and Gary N. Horlick, Debra A. Valentine, and Debra P. Steger, *Two Views on Dispute Settlement and Trade Laws in the Canada-U.S. Free Trade Agreement*, Trade Monitor 6 (Toronto: C.D. Howe Institute, 1988).

2 For a detailed analysis of this point, see Horlick, Valentine, and Steger, *Two Views on Dispute Settlement and Trade Laws*.

3 For the detailed analysis, see Edward A. Carmichael, *Energy and the Canada-U.S. Free Trade Agreement*, Trade Monitor 4 (Toronto: C.D. Howe Institute, 1988).

4 For a detailed analysis, see A.E. Safarian, *The Canada-U.S. Free Trade Agreement and Foreign Direct Investment*, Trade Monitor 3 (Toronto: C.D.Howe Institute, 1988).

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